The Economic Predicament of the United States and the Federal Reserve's Response in a Globalized World

Remarks before Tsinghua University's School of Economics and Management

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you. I am delighted to be here at Tsinghua University, together with my colleagues, Mark Wynne, who is director of the Federal Reserve Bank of Dallas' Globalization and Monetary Policy Institute, and Tao Wu, a Hubei-born senior economist and policy advisor at the Dallas Fed.

I may have the longest experience in China not only of any Federal Reserve official, but perhaps of any American policymaker you will ever meet! My native Australian father and South African-born mother sailed out of Shanghai on the *S.S. President Wilson* just as the port was being shut down by the soon-to-be victorious forces of the Communist revolutionaries in 1948. In a story too long to tell here, my father had been dispatched to collect a dollar payment owed an American company—the Spazier Chemical and Soap Company. They left Shanghai for the U.S. with more than the money due Spazier: My mother was with child—me—and I was born the following March.

So my bona fides for standing at this lectern at this prestigious university in Beijing to discuss the economic predicament of the United States (and the Federal Reserve's response) in a globalized world are as follows: I was assembled by an Australian–South African consortium in China, then shipped across the Pacific to become one of the innumerable factors that make for a dynamic economy that is uniquely American. When I served my government as an ambassador and trade representative in negotiating the bilateral aspects of your country's accession to the World Trade Organization (WTO), Madame Wu Yi once told me, "Of course you have done well in America. You were manufactured in China!"

Thirty years after my date of "manufacture," I served in the Carter administration as coordinator of policy planning and assistant to Treasury Secretary Michael Blumenthal. Secretary Blumenthal brought me to China in 1979. I mention this for a reason. That early experience in China, coupled with my involvement 20 years later as deputy U.S. trade representative in negotiating China's accession to the WTO for President Clinton, forms the lens through which I now view China's success, challenges and potential.

I am going to anchor my remarks today with some perspectives gained from that trip to China in 1979. Then I will turn to the economic situation of the United States and the Federal Reserve's response, in keeping with our duties as the central bank of the largest economy in the world. Finally, I will endeavor to answer any questions you wish to ask.

Throughout, please bear in mind that I am a Texan. Texans speak plainly and directly. In an academic setting like Tsinghua, I trust you will consider my candor as keeping fully in the spirit of intellectual exchange.

A Short Historical Perspective

President Nixon famously normalized political relations with China in his meetings with Mao Zedong and Zhou Enlai in 1972. It fell to President Carter, however, to settle the counterclaims between the U.S. and China that stemmed from the Communist takeover in 1949. Chairman Mao's forces did not seize the cash of Spazier Chemical and Soap, but they did seize the railroad stock and other assets the U.S. had lent to the Nationalist government; the U.S. government, in turn, retaliated by freezing China's accounts in U.S. banks. Without settling those counterclaims, we could not normally trade with each other. So after months of rigorous preparation, at the behest of President Carter, Secretary Blumenthal and his team, including me as the secretary's faithful chef de cabinet, dispatched to Beijing on Feb. 23, 1979, to settle the claims. We met with Secretary Blumenthal's official counterpart, Finance Minister Zhang Jin-fu, then with Deng Xiaoping and Chairman Hua Guofeng.[1] We sealed the preliminary deal on March 1, after arduous negotiations with Deng, and that day officially raised the flag over the American Embassy in Beijing, establishing the fulsome diplomatic presence of the United States in China.

The memories of that trip flooded back as I prepared for today's lecture.

When we landed in Beijing on Saturday night, Feb. 24, 1979, our delegation was whisked off to the official guesthouse in Red Flag limousines. The roads into Beijing had no cars—not because the route had been cordoned off for our delegation but because there simply weren't any. What traffic we did see included skinny horses, donkeys, camels, oxen, exhaust-spewing trucks and countless bicycles made in the Forever bicycle factory in Shanghai for the purpose of realizing Zhou's "four modernizations."

That was my first hands-on impression of China: There were no cars. Imagine that! Now, 30 years later, anybody attempting to navigate Chang'an Avenue on a bicycle would be taking his life in his hands. Beijing alone has over 2.5 million cars, and China overall roughly 40 million.

After we reached the initial agreement to settle our claims, we flew to Shanghai on a People's Liberation Army plane for a little R&R before returning to Beijing to tidy up some fine points and sign our accord. Your government had thoughtfully picked out the prettiest military women they could muster to serve us drinks and meals on the flight. On a whim, my counterpart and seat mate from the State Department, Robert Hormats, who is now vice chairman of Goldman Sachs, took out a Polaroid camera and took a picture of these impromptu flight attendants. You would have thought he had struck a match in some far corner of the world where fire had never been seen. The flight attendants squealed with delight, and the entire crew, including the pilots, came to the back of the plane to examine this previously unseen, newfangled technology that allowed photographs to develop after only a minute or so. Think about that. This was roughly a quarter century after Polaroid had become commonplace in the U.S. and four years after the first user-friendly personal computer was brought to market by Steve Jobs and the Apple Corporation. Yet, the Chinese public had never seen an "instant" camera, let alone heard of a personal computer.

Polaroid has since filed for bankruptcy, having been overtaken by microprocessor-driven electronic cameras and photo-capable cell phones. Today, China annually produces roughly 100 million microcomputers, and it has 650 million domestic cell phone subscribers. Your country

[1] Two of my favorite mementos are one of me standing above and right behind Deng in a group photo and another that appeared on the front page of the *People's Daily* on March 1, 1979, of Hua escorting Secretary Blumenthal, Treasury Undersecretary Anthony Solomon and Assistant Secretary of State Jules Katz, with me in tow, into the Great Hall of the People.

has become the world's largest producer of semiconductors and the leading exporter of information technology goods.

Which brings me to China's willingness to adopt and adapt. When Deng Xiaoping entered the room for the initial encounter with our delegation in the Great Hall of the People, he cackled, "Where are these big American capitalists we Chinese are supposed to be so afraid of?" During our meeting, he made a remark that paralleled his famous "black cat, white cat" theme—"it doesn't matter if the cat is white or black as long as it catches mice." Deng's remarks encapsulated the importance of practical results over political correctness and economic development over ideological purity—both hallmarks of modern China. Deng made it clear to our delegation that China was intent on modernization and that the Chinese cat would be focused on catching droves of economic mice as it engaged the rest of the world, starting with the inputs and access from trade that would be liberated with our settlement that week.

This China has done. In 1979, the U.S. imported a mere $595 million from China under onerous tariffs; the Chinese did not have a single dollar in official reserves. Now, you send more than $300 billion in goods annually to the U.S. and hold on the order of $2 trillion in foreign exchange reserves, a majority component of which are U.S. dollar-denominated securities. Until recently, since Deng's ascendancy, China has grown its economy at around 10 percent per annum, has become the world's pivotal factory and is quickly moving to the cutting edge of technology.

It is worth noting that Deng and his successors' approach to modernization differed from that of Japan. A contemporary of Deng Xiaoping told me that in a conversation with him in 1978, Deng had decided that, unlike Japan's decision to utilize national champions to build its economy and *then* engage the world to leverage Japanese prosperity, the Singapore model of attracting the best and brightest from around the world *up front* would better pave the way for domestic development and quick growth. Thus, from the get-go, China has had an inherent stake in the success of globalization.

One final impression from that trip in 1979: During that trip, we were treated to a soiree in the Great Hall of the People on Feb. 27. The seventh act of the evening was a piano recital—a performance of Liszt's "Hungarian Fantasy No. 6"—by a pianist named Liu Shikun. Today, Liu is regarded as China's finest pianist; he has performed worldwide, including with Seiji Ozawa and the Boston Symphony for one of the best-selling classical music albums of all time. He had given his premiere performance at the age of 5. In 1949, at the age of 10, he had won the Chinese National Competition for Teenagers and Children. In 1956, at the age of 17, he was so brilliant in his performances around the world that the Hungarian government presented him with a lock of Liszt's hair. He was a boy wonder, a musical genius who won innumerable international competitions worldwide.

If you read Liu's official Chinese biography, you will note that "he has performed in front of several generations of Chinese statesmen, including Mao Zedong … Deng Xiaoping, Jiang Zemin and Hu Jintao." What it does not tell you is that he was imprisoned during the Cultural Revolution and, we were told, maintained his skills by carving a keyboard on the wall of his cell and playing it day after day, hearing its music only in his imagination. His performance for us that February evening in 1979 was one of his first public appearances since his "rehabilitation," and it was so stirring that even our Chinese hosts were moved to tears.

Whenever I contemplate China's capacity to succeed in the global economy, I think of those first impressions of China of 30 years ago—the paucity of automobiles and the absence of computers; the determination of Deng Xiaoping to harness the best talent and techniques from all over the world; the example of the triumph over misguided policy that is embodied in the spirit and genius of Liu Shikun. And I conclude that as long as China continues to constructively engage the rest of the world and allow the tremendous talent of the Chinese people to flourish, the People's Republic will not only be able to withstand the setbacks currently afflicting the global economy, but will continue to advance its standing as an economic juggernaut.

Of course, in a globalized economy, we are all interdependent. To prosper, China needs and expects the largest economy of the world to overcome its economic and financial travails and lead the way to a global economic recovery. So let me now give you a briefing on the current U.S. situation.

The Present Situation

The data from the United States are grim. Our economy contracted at an annual rate of 6.3 percent in the fourth quarter of last year. I expect that when the numbers are properly tallied, we will have again contracted at a dispiriting rate in the quarter just ended. Unemployment is rising. We currently have roughly 13.2 million people without jobs, which equates to an unemployment rate of 8.5 percent. I expect the unemployment rate to continue rising to a level that could surpass 10 percent by year-end. Even in Texas, the most dynamic of the American states and the only large province in the U.S. to create jobs last year, we expect unemployment to rise, though not to national levels.

Among other things, this has compounded the problem of the much-watched housing market, where many of the problems we have encountered in our financial markets germinated: The most recent release of the Case-Shiller index reveals that home price declines accelerated in the 20 metropolitan districts tracked. Prices fell 19 percent on a year-over-year basis for the three-month period ended in January. But the problem with our economy is more pervasive. The men and women who operate our businesses and create and sustain employment have assumed an uncharacteristic defensive crouch. Confronted by dyspeptic financial markets, they are doing the best they can to preserve their margins by cutting costs (most significantly, the cost of labor), and running tight inventories, rationalizing supply lines, deferring all but the most necessary capital expenditures and, in general, avoiding risk. The result is an American economy in stasis. Presently, nothing is being ventured, and nothing is being gained.

Of course, not helping matters is the implosion of our export markets, which are vital to the growth of an economy positioned to sell high-value-added goods and services—as well as agricultural and other basic goods—to others. The World Bank is predicting that global trade will contract by 6.1 percent in 2009.[2] The WTO is forecasting a 9 percent contraction.[3] This will be the first time since the 1940s that we have witnessed such a deep and synchronized

[2] "As Global Economy Deteriorates, World Bank Predicts Sharply Slower Growth in Developing World in 2009; Weak Recovery in 2010," World Bank Press Release No. 2009/285/DEC, March 31, 2009.
[3] "WTO Sees 9% Global Trade Decline in 2009 as Recession Strikes," World Trade Organization Press Release No. Press/554, March 23, 2009.

retrenchment of global economic activity, and this makes tougher the task of growing the U.S. economy.

One of our founding fathers, James Madison, considered to be the father of the (American) Constitution, wrote that "the circulation of confidence is better than the circulation of money."[4] There is presently a palpable lack of circulating confidence in the business community in America. Only when confidence is restored will the U.S. economy begin to grow again.

Capital is the basis of capitalism. Without efficiently operating credit markets, the muscles of the economic body—private businesses that produce goods and services and employ workers and are the engines of prosperity—cannot function. Thus, the Federal Reserve has assumed a dramatically proactive and highly innovative role in seeking to restore vibrancy in the credit markets while stemming economic decline. This is an unaccustomed thing for our central bank. Ordinarily, the men and women of the Federal Reserve are the most shy and modest of economic agents. We prefer to move incrementally rather than exponentially, and we have historically treasured conducting our deliberations quietly and away from the public limelight. But confronted with a dysfunctional financial market and an implosion in our economy, in rapid order we have undertaken a series of very visible and widely broadcast initiatives. Over a period of a little more than a year, we:

—Established a lending facility for primary securities dealers, taking in new forms of collateral to secure those loans;

—Initiated so-called swap lines with the central banks of 14 of our major trading partners, ranging from the Bank of Japan to the European Central Bank and the Bank of England to the Banco de México to the Monetary Authority of Singapore and the Korean Central Bank, to provide these foreign central banks with the capacity to deliver U.S. dollar funding to financial institutions in their jurisdictions. We also have put in place swap agreements with four of our counterparts—the Bank of Japan, the European Central Bank, the Bank of England and the Swiss National Bank—to enable the Federal Reserve to provide up to 10 trillion yen, 80 billion euro, 30 billion in sterling and 40 billion in Swiss franc liquidity to U.S. financial institutions as a reciprocal prophylactic measure;

—Created facilities to backstop money market mutual funds;

—Initiated new measures in cooperation with the Treasury and the Federal Deposit Insurance Corporation to strengthen the security of certain banks;

—Undertook a major program to purchase commercial paper, a critical component of the financial system;

—Began to pay interest on bank reserves;

—Announced we stood ready to purchase up to $100 billion of the direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, then increased that sum to $200 billion;

[4] Speech in the Virginia Ratifying Convention on the Judicial Power, June 20, 1788.

—Announced we would buy $500 billion in mortgage-backed securities backed by Fannie, Freddie and Ginnie Mae, then increased *that* sum to $1.25 trillion;

—Announced, and just recently fleshed out, a new facility to support the issuance of asset-backed securities collateralized by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration, a facility that we have since stated we were prepared to expand significantly to other types of securities and beyond our originally planned $200 billion to $1 trillion; and

—Began the process of purchasing up to $300 billion of longer-term Treasury securities over the next six months to help improve conditions in private credit markets.

And, in a series of steps, the Federal Open Market Committee reduced the fed funds rate to between zero and one-quarter of 1 percent. Simultaneously, at the request of the 12 Federal Reserve Banks, and again in a series of steps, the Board of Governors lowered the rate we charge banks to borrow from our discount windows, so as to lower the cost of credit to the economy.

All of this has meant expanding the Federal Reserve's balance sheet. As of today, the total footings of the Federal Reserve have expanded to roughly $2 trillion—more than a twofold increase from when we started in 2008. It is clear that we will grow our balance sheet even more as we complete our programs of purchasing longer-term Treasuries, expanding our holdings of mortgage-backed paper and purchasing larger amounts and different forms of asset-backed paper.

By being so proactive in straying from our usual business of holding plain vanilla, mostly short-term Treasuries as assets and by shifting policy away from simple titrations of the fed funds rate, we have raised a few eyebrows. But these are complex, trying times. Our economy faces a tough road. We are the central bank of the largest economy in the world, and we are duty bound to apply every tool we can to clean up the mess that our financial system has become and get back on the track of sustainable economic growth with price stability.

This expansion of our balance sheet has given rise to concerns that we may be:

1) Planting the seeds of future inflation; and
2) Setting the stage for a demise of the dollar.

I understand these concerns. Especially from a Chinese perspective. Just as the effects of the arduous work and admirable thrift of the Chinese people are coming into fruition, your largest export market and source of much investment—the United States—enters a bone-crushing recession. And simultaneously, the largest and most liquid market for investing the hard-earned savings and reserves you have accumulated have become extraordinarily volatile.

It would be only natural for your leaders to wonder if the remedies we are applying to treat our economic pathology might eventually result in inflation and depreciation of the dollar.

So let me address each of these concerns in order.

First, with regard to the potential inflationary consequences of our actions: Our assignment is to conduct monetary policy so as to engender sustainable, noninflationary job growth. Presently, the risk is deflationary job destruction. We have undertaken measures to counter that risk. And we seek to do so in a way that will not ignite the embers of either a future destructive inflation or a debasement of our currency.

I have a reputation for being the most "hawkish" participant in the deliberations of the Federal Open Market Committee. I do not particularly like ornithological nomenclature—I would rather be considered a wise owl (and I certainly do not wish to be anybody's pigeon). But I have a record that substantiates that "hawkish" reputation, having voted five times against monetary accommodation during the commodity-driven price boom of 2008. I consider inflation an evil spirit that rots the core of economic prosperity and must never, ever be countenanced. But it is clear to me that in this environment, inflation is unlikely to present a serious threat given the pervasive bias in the U.S. economy toward wage cuts and freezes, rising unemployment, the widespread loss in wealth that has resulted from both the housing and equity market corrections, continually declining consumption and business investment, and the anemic condition of the banking and credit system, all of which reinforce downside price pressures in a global economy groaning with excess capacity.

For as far ahead as I trust my forecasting ability[5] (that is to say, the next couple of years), the problem with regard to maintaining price stability most certainly is not inflation.

With regard to the fate of the dollar and the willingness of others to continue purchasing dollar-denominated debt, we realize that by purchasing Treasuries in volumes and of durations that are atypical, we are at risk of being perceived as monetizing the fiscal largesse of our Congress. And we are acutely aware that by intervening in the mortgage-backed securities and other markets that we are at risk of being perceived as blurring the lines between fiscal and monetary policy. We realize that this may give rise to some apprehension among large holders of Treasuries and agency paper such as your government and others in the Asian-Pacific region.

And yet, let me remind you that over the past year since we began in earnest the process of using the new tools I have just articulated, the dollar has appreciated 17 percent against the euro and 29 percent against the British pound. Against the major reserve currencies, the dollar has depreciated against only one, the yen, and by 2 percent.

Here are some numbers for you to contemplate: If a Chinese investor had purchased a three-month U.S. Treasury bill in March 2008 and rolled it over every three months until the end of this past month, the return would have been a negative 1.5 percent. That is hardly inspiring. But, had that same investor purchased and rolled over a three-month euro-area central government bond, the investment would have resulted in a loss of 16 percent.

I would add that a foreign investor who moved out on the Treasury yield curve would have enjoyed superior returns to those just cited. In yuan terms, 10-year euro sovereigns would have earned a return of *negative* 11.6 percent over the past year. The equivalent return would have been a *positive* 9.5 percent for the Chinese investor in 10-year U.S. Treasuries. If I may

[5] I have never forgotten the admonition of one of my economics professors at Harvard—John Kenneth Galbraith—that "the only function of economic forecasting is to make astrology look respectable."

paraphrase Andrew Mellon, at least for the period over which the Fed has been applying its new tools, it has been quite true that "gentlemen prefer American bonds."

Certainly for the past year to date, fears of debasement of fixed-income portfolios invested in dollar-denominated public debt due to the profound actions taken by the Federal Reserve have proven unfounded.

But that is in the past. As to the future, the underlying math becomes more complex: The net new supply of Treasury debt is predicted to expand by $2.5 trillion in the current fiscal year, versus $788 billion in the last fiscal year and only $145 billion in fiscal year 2007.[6] All things being equal, this would result in a move upward in yield and downward in price, providing negative returns absent any foreign exchange factor. But all things are not equal. For starters, the problems facing the largest competitive currency, the euro, are perhaps even more substantial than those confronting the United States. I will point to Spain as an example of a euro-area economy that led the European pack on the upside and now is cascading rapidly downhill. In the case of Japan, you are as aware as anybody of the economic and fiscal and political predicament they are faced with; I will say no more. My point is that demand for Treasuries and other official paper of U.S. government issuers will be determined by their attractiveness relative to alternatives, and they may well be judged more, rather than less, attractive under most reasonable future scenarios.

Moreover, both the fate of budget imbalances and the potential for total returns earned by investing in U.S. securities depend on the efficacy of the fiscal policies Congress has advanced. These policies are designed to jump-start the economy while laying the groundwork for permanent structural reform. Time will tell if they achieve this multipurpose goal. If they do, they will engender growth of the economy and concomitant confidence in both the fixed-income and equity markets for private securities. In addition, tax flows will be restored and confidence boosted in the path of deficit reduction envisioned by the current administration in its budget projections. If these policies don't jump-start the economy, then I am confident that the reaction within fixed-income markets will force those with the power to tax and spend, the Congress, to readjust their fiscal policies.

I offer as evidence the revelation that came to the fiercely partisan Democratic operative James Carville during the Clinton administration. He said that were he to be reincarnated and wished to be the most powerful of all, he would come back not as a president or emperor or pope but as the bond market, for "[the bond market] can intimidate anybody."[7] I suspect this respect for the power of bond markets remains true for the Obama administration and the current Congress.

Of course, to maintain price stability and faith in the dollar, we must maintain the independence of our central bank, the Federal Reserve. The dangers that arise when monetary authorities become the handmaidens of political authorities are documented in countless historical examples—from the fall of ancient Rome to the Weimar Republic in Germany to the Nationalist Chinese government in the 1940s to modern Zimbabwe. In 2013, we will celebrate our 100th anniversary as the central bank of the United States. We are not as established as an ongoing entity as the Bank of England, nor as young as institutions such as the People's Bank of China.

[6] "Fed Home Loan Purchases Fail to Keep Mortgage Rates from Rising," *Financial Times*, Feb. 9, 2009.
[7] James Carville, as quoted in the *Wall Street Journal*, Feb. 25, 1993.

This is not to say we are superior or always exemplary, but we are an elder in this business. We seek to be worthy of the veneration traditionally given to an elder. To this end, we must zealously guard our ongoing independence.

We have recently agreed with the U.S. Treasury to an accord to work together to support the goals of preserving both monetary and financial stability.[8] In this endeavor, it is the Federal Reserve's job to maintain monetary stability, while the Treasury will enable the Fed to sterilize the impacts of its lending and securities purchases on its balance sheet—and on the balance sheet of the banking system. In essence, the Federal Reserve will not monetize the growth of the assets on its balance sheet that has been, and will continue to be, necessary to jump-start the credit markets that are so essential to the recovery of the U.S. and global economies. To put it another way, the Federal Reserve is in the process of acquiring the tools to short-circuit any inflationary consequences of its balance sheet growth.

In contemplating the future of the American economy and our ability to overcome our current financial predicament, I take great comfort in knowing that we have been faced with far tougher tasks and have always accomplished them. It is true that we Americans often confront storms of our making. We occasionally falter and get blown off course. But we never give up. And we always come roaring back stronger, leaner and more efficient than we were before. For 233 years, the people of the United States have demonstrated that they are masters of the process of creative destruction that economist Joseph Schumpeter articulated as the key to success for any economy, be it built upon Anglo-American or Asian-Pacific or any other principles.

Our recent presidential election demonstrates that we are still possessed of a vibrancy and adaptability that the French social philosopher Alexis de Tocqueville found so inspiring in the early 19th century. As an American, I may be insufficiently humble—humility is, after all, anathema to Texans—but I think it reasonable to consider our track record and our adaptability to be the stuff of an eventual recovery that will take my country to new levels of prosperity. I am confident that the innovative policies being pursued by the Federal Reserve will facilitate and, indeed, expedite the recovery process. In doing so, we will serve not only the interests of the United States but also those of China. For without restoration of American prosperity, China cannot realize the successful accomplishment of the course I personally witnessed Deng Xiaoping initiate—a course his successors have so assiduously built upon and are working so hard to complete.

Now, in the tradition that is the hallmark of central bankers everywhere, I will do my utmost to avoid answering any questions you may have. That's a joke. I will be glad to answer questions in a straightforward manner for as long as you wish to ask them.

[8] Federal Reserve Board and Department of the Treasury Joint Press Release, March 23, 2009.